[JOINT COMMITTEE PRINT]

FEDERAL TAX TREATMENT OF FAMILIES BELOW THE POVERTY LINE

Scheduled for a Hearing

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

ON APRIL 12, 1984

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OF THE

JOINT COMMITTEE ON TAXATION

APRIL 9, 1984

U.S. GOVERNMENT PRINTING OFFICE
32-964 O WASHINGTON : 1984 JCS-15-84

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INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a hearing on April 12, 1984, to examine the Federal tax treatment of low-income taxpayers and the poor. This pamphlet discusses recent trends in the level of income at which a family begins to pay Federal income tax (the tax threshold), provisions of law affecting the tax threshold, the amount of tax paid at the poverty level, and possible changes to alleviate income tax burdens on the poor.

This material was originally printed as section 10 of "Background Material on Poverty," Subcommittees on Oversight and Public Assistance and Unemployment Compensation, Committee on Ways and Means, October 17, 1983 (WMCP 98-15). The only new material in this pamphlet is the updating of Table 1 to include figures for 1985 and 1986, Table 3 to include figures for 1985 (and the related text), as well as minor editorial changes.

I. Relationship Between Income Tax Threshold and Poverty Line in Recent Years

Through the 1960's and 1970's Congress attempted, in several tax reduction bills, to eliminate the tax burden on families whose incomes were below the poverty line. The legislative history of the tax cut bills enacted in 1969, 1975, 1976, 1977, and 1978 indicates a Congressional desire to increase the level of income at which a family begins to pay Federal income tax (termed the tax threshold or, alternatively, the tax entry point) above the poverty level. Several tools have been used to achieve this goal: the personal exemption, the standard deduction (now termed the zero bracket amount) and the earned income tax credit. In the past few years, however, these provisions have not kept pace with inflation, and as a result the income tax threshold has fallen well below the poverty line.

Table 1 shows the Federal income tax threshold and the poverty line for a family of four for selected years between 1959 and 1985. In 1960, the tax threshold was 10.3 percent below the poverty line. As a result of the 1964 tax cuts, the gap between the two was cut to 6.9 percent by 1965. By 1969, inflation had increased the gap to 19.9 percent, and Congress responded by enacting tax reductions in 1969 and 1971 which succeeded in eliminating the gap in 1972. The rapid inflation of 1973–74 caused the gap to reemerge, and in 1975 the tax cuts were so structured that the tax threshold was raised 21.7 percent above the poverty line. The earned income tax credit, enacted that year, was designed not only to remove poor people from the income tax rolls but also, through its refundable feature, to offset some of the impact of the social security payroll tax on their earnings. However, inflation since 1975 left the tax threshold 11.5 percent below the poverty level in 1982, and it is estimated that in 1985 and 1986 the gap will increase to 19.5 percent and 21.5 percent, respectively, the largest gap since before 1959. This shortfall will continue to grow for some families even after indexing takes effect in 1985, since the earned income credit is not indexed. If indexing were not to go into effect, the gap would grow even faster, reaching 20.9 percent by 1985 and 24.3 percent by 1986.

TABLE 1.—RELATIONSHIP BETWEEN INCOME TAX THRESHOLD AND POVERTY LEVEL FOR A FAMILY OF FOUR, 1959–1986

Year	Income tax threshold	Poverty level	Percentage gap between tax threshold and poverty level
1959	$2,667	$2,973	−10.3
1960	2,667	3,022	−11.7
1965	3,000	3,223	−6.9
1966	3,000	3,317	−9.6
1968	3,000	3,553	−15.6
1969	3,000	3,743	−19.9
1970	3,600	3,968	−9.3
1971	3,750	4,137	−9.4
1972	4,300	4,275	+0.6
1973	4,300	4,540	−5.3
1974	4,300	5,038	−14.6
1975	6,692	5,500	+21.7
1976	6,892	5,815	+18.5
1977	7,533	6,191	+22.0
1978	7,533	6,662	+13.1
1979	8,626	7,412	+16.4
1980	8,626	8,414	+2.5
1981	8,634	9,287	−7.0
1982	8,727	9,862	−11.5
1983	8,783	[1] 10,166	[1] −13.6
1984	8,783	[1] 10,613	[1] −17.2
1985	8,936	[1] 11,101	[1] −19.5
1986	9,102	[1] 11,601	[1] −21.5

NOTE.—Tax thresholds assume full use of the earned income tax credit.

[1] Estimated.

II. Provisions of Law Affecting Income Tax Threshold

The provisions of the tax law that have affected the Federal income tax threshold in recent years are displayed in Table 2. These are the personal exemption and standard deduction (now the zero bracket amount), both of which have been in the law for many years, and the earned income tax credit (enacted in 1975). In addition, a general tax credit was in effect between 1975 and 1978 and had a significant impact on the tax entry point in those years.

TABLE 2.—FEDERAL INCOME TAX PROVISIONS RELEVANT TO TAX THRESHOLDS

Year	Personal exemption	Minimum standard deduction for joint returns (zero bracket amount)	Earned income tax credit	General tax credit
Pre-1964	$600	10% of income	N.A.	N.A.
1964-69	600	$200 plus $100 per exemption.	N.A.	N.A.
1970	625	1,100	N.A.	N.A.
1971	675	1,050	N.A.	N.A.
1972-74	750	1,300	N.A.	N.A.
1975	750	1,900	$400, phased out between 4–8K of AGI..	$30 per exemption.
1976	750	2,100	Unchanged	35 per exemption.
1977-78	750	3,200	Unchanged	Unchanged.
1979-84	1,000	3,400	$500 phased out between 6–10K of AGI..	N.A.
Post-1984	$1,000 adjusted for inflation.	$3,400 adjusted for inflation.	......do	N.A.

N.A.—Not applicable in that year.
K—thousands.

Personal exemption

The personal exemption, which is subtracted in determining taxable income, is the principal provision of the law that differentiates the tax burden by family size. Taxpayers each receive one personal exemption (one for a single return and two for a joint return), and an additional exemption is allowed for each dependent. Also, there are extra exemptions for the blind and for people age 65 or over. The exemption remained at $600 between 1948 and 1969, after which it was increased in stages to $750. The Revenue Act of 1978 increased the exemption further to $1,000. After 1984, it is scheduled to be indexed for inflation.

The present $1,000 exemption is much smaller, when adjusted for inflation, than was the $600 exemption in 1948: $600 in 1948 would be worth $2,500. The exemption has not kept pace with inflation since 1964: $600 in 1964 would be worth $2,000 today. As a result of the erosion of the real value of the exemption, the difference in tax burdens between large and small families has been gradually narrowing. As a result, the current gap between the tax entry point and the poverty line is especially large for large families.

Zero bracket amount (standard deduction)

The zero bracket amount (ZBA) originated as a standard deduction, designed to give taxpayers an alternative to itemizing their personal deductions. Prior to 1964, the standard deduction equaled 10 percent of adjusted gross income (subject to a maximum) and was subtracted by nonitemizers in determining taxable income. However, starting in 1964, Congress began to target the standard deduction toward lower-income taxpayers. That year, the minimum standard deduction (also called the low-income allowance) was enacted and equaled $200 plus $100 for each personal exemption (i.e., $600 for a married couple with two children). In 1969, the minimum standard deduction was increased to $1,100 for 1970 and $1,050 for 1971. The 1971 and 1975 tax cuts increased the minimum standard deduction for joint returns to $1,300 and $1,900, respectively. Also, in 1975 the minimum standard deduction was established at a lower level for single returns ($1,600) than for joint returns ($1,900).

In 1977, the standard deduction was set at a flat amount for all taxpayers ($2,200 for single returns and $3,200 for joint returns), built into the tax schedules as a tax bracket with a zero rate and renamed the zero bracket amount. The current levels of the ZBA are $2,300 for single returns and $3,400 for joint returns ($1,700 for married persons filing separate returns) and were established in 1978, effective for 1979. Under the new system, the standard deduction is no longer deducted in determining taxable income, and instead all taxpayers pay a zero tax on the first $2,300 and $3,400 of their taxable income. Itemizers must substract their zero bracket amount (ZBA) from their itemized deductions which, in effect, cancels out the benefits they receive from the zero bracket. After 1984, these amounts are scheduled to be indexed for inflation.

For a taxpayer not eligible for the earned income credit, the personal exemption and the zero bracket amount determine the tax entry point. Thus, for a single taxpayer, the tax entry point is

$3,300 ($1,000 exemption plus $2,300 ZBA). For a married couple, it is $5,400 ($2,000 exemption plus $3,400 ZBA). For a married couple with two children which is not eligible for the earned income credit, the tax entry point is $7,400 ($4,000 exemption plus $3,400 ZBA).

Earned income tax credit

The earned income tax credit was enacted in 1975 as a way of targeting tax relief to working low-income taxpayers with children, providing relief from the payroll tax for these taxpayers, and improving work incentives. It is subtracted from tax liability. Unlike other tax credits, the earned income credit is refunded to the taxpayer to the extent it exceeds tax liability (i.e., it is a refundable credit). As originally enacted, the credit equaled 10 percent of the first $4,000 of earned income (a maximum credit of $400) and was phased out as income grew from $4,000 to $8,000. In 1978, the maximum credit was increased to $500 (10 percent of the first $5,000 of earned income), and the phaseout was raised to between $6,000 and $10,000 of income. A system of advance payments also was enacted in that year; under this provision eligible individuals may receive the credit with their paychecks rather than waiting until a tax refund is received after the end of the year. The credit is available only to persons with dependents. Unlike the personal exemption and the zero bracket amount, the dollar amount in the earned income credit are not scheduled to be indexed for inflation after 1984. The tax thresholds computed in Table 1 include the impact of the earned income credit for the years after 1974. Thus, for a four-person family for 1983, the tax entry point ($8,783) is the income level at which the tax before credits exactly equals the allowable earned income credit.

General tax credit (1975–1978)

Between 1975 and 1978, Congress adopted a temporary general tax credit as an additional means of providing tax relief to lower-income persons. As enacted in 1975, the credit was $30 for each personal exemption. In 1977, it was increased to the greater of $35 per exemption or 2 percent of the first $9,000 of taxable income. The 1978 tax reduction eliminated the general tax credit, replacing it with an increase in the personal exemption. Unlike the earned income credit, the general tax credit was not refundable.

III. Amount of Tax Paid at the Poverty Level

Table 3 shows the income tax threshold and the poverty level for various family sizes for 1978 and the years 1982 through 1985. Poverty levels for years after 1982 are based on assumptions that the rate of inflation was 3.1 percent in 1983, and will be an estimated 4.4 percent in 1984 and 4.6 percent in 1985. The table also assumes that all income is wages or salaries, that families of two or more include a married couple, and that families of three or more persons are eligible for the earned income credit.

In 1978, the poverty level exceeded the income tax threshold only for single persons, and the maximum income tax paid by a poor single person was only $16. For three- and four-person families at

the poverty line, the earned income credit offset a substantial part of the payroll tax.

In 1983, the income tax threshold exceeded the poverty level only for three-person families. For four-person families, the shortfall of the tax threshold below the poverty level was $1,383, and for six-person families it was $3,901. In 1984, prior to the commencement of indexing, the tax threshold is estimated to be approximately equal to the poverty level for a three-person family but will be $1,830 below if for a four-person family, and $4,500 below it for a six-person family. Even after indexing takes effect (1985), the gap between the tax threshold and the poverty level will grow faster than the rate of inflation for these families. For 1985, the shortfall of the tax threshold below the projected poverty level is estimated to be $2,433 for a two-person family, $2,165 for a four-person family, and $4,960 for a six-person family. This will happen because a taxpayer at the tax threshold is still eligible for the earned income credit and will be affected by the failure to index that credit.

Table 3 also shows the amount of income tax and payroll tax that is paid by someone whose income equals the poverty line and whose income is fully subject to tax. While many poor people do receive cash transfer payments that are tax-exempt and, therefore, would not be subject to the tax burdens shown in Table 3, there are many poor people who must rely on their earnings and for whom these tax burdens can result under present law. In 1984, a four-person family whose income is at poverty level can pay as much as $365 in income tax, and a six-person family as much as $570. The table also shows the payroll taxes paid by an earner whose earnings are at the poverty level. In 1975, Congress had hoped to eliminate some of this burden by the refundable earned income credit, but since then inflation has raised tax liabilities and the poverty level so that the credit, which does not apply to families with incomes above $10,000, does not give any benefit to a significant number of poor families. The table also shows the combined income and payroll tax burden at the poverty level as a percent of income. For 1984 and 1985, the table indicates that this can be as high as 11 percent of income.

TABLE 3.—TAX THRESHOLDS, POVERTY LEVELS, AND FEDERAL TAX AMOUNTS FOR DIFFERENT FAMILY SIZES WITH EARNINGS EQUAL TO THE POVERTY LEVEL, 1978–1985

	Family size					
	1	2	3	4	5	6
Income tax threshold:						
1978	$3,200	$5,200	$6,930	$7,520	$8,183	$9,167
1982	3,300	5,400	8,237	8,727	9,216	9,706
1983–84	3,300	5,400	8,315	8,783	9,251	9,719
1985	3,445	5,638	8,447	8,936	9,424	9,913
Poverty level:						
1978	3,311	4,249	5,201	6,662	7,880	8,891
1982	4,900	6,280	7,690	9,860	11,680	13,210
1983	5,052	6,475	7,928	10,166	12,042	13,620
1984	5,274	6,760	8,277	10,613	12,572	14,219
1985	5,517	7,071	8,658	11,101	13,150	14,873
Income tax at poverty level:						
1978	16	0	−280	−134	−12	0
1982	202	106	−134	285	417	491
1983	206	118	−91	318	431	507
1984	226	150	−9	365	480	570
1985	237	158	50	383	504	599
Payroll tax at poverty level:						
1978	200	257	315	403	477	538
1982	328	421	515	661	783	885
1983	338	434	531	681	807	913
1984	353	453	555	711	842	953
1985	389	499	610	783	927	1,049
Combined income and payroll tax at poverty level:						
1978	216	257	35	269	465	538
1982	530	527	381	946	1,200	1,376
1983	544	552	440	999	1,238	1,420
1984	579	603	546	1,076	1,322	1,523
1985	626	657	660	1,166	1,431	1,648
Combined tax as percent of income at poverty level:						
1978	6.5	6.1	0.7	4.0	5.9	6.1
1982	10.8	8.4	5.0	9.6	10.3	10.4
1983	10.8	8.5	5.5	9.8	10.3	10.4
1984	11.0	8.9	6.6	10.1	10.5	10.7
1985	11.3	9.3	7.6	10.5	10.9	11.1

IV. Possible Changes To Alleviate Income Tax Burdens on the Poor

In terms of aggregate revenue loss per dollar of benefit to poor taxpayers, the two most cost-effective tools to reduce the tax burden of the poor are the earned income credit and the zero bracket amount.

Earned income tax credit

The earned income credit is phased out for incomes above $10,000 and, therefore, all of the benefits from increasing the credit go to people with incomes below the phaseout. The credit is not now available to single persons or couples without dependents and, therefore, does not raise the tax entry point for these taxpayers. Furthermore, the amount of the credit does not change as the number of dependents increases; therefore, it is not a very good tool, as presently structured, to raise the tax entry point for very large families. There have been suggestions to vary the earned income credit by family size. These have been criticized on the grounds that they would make the credit more of a welfare program and less of a way of alleviating the burden of the payroll tax on poor people and less of a way of providing work incentives for low-income earners. In addition, such a proposal would present significant technical problems with respect to single parents who are maintaining a household.

In 1981, the version of the tax cut bill reported by the Committee on Ways and Means would have increased the rate of the earned income credit from 10 percent to 11 percent, thereby raising the maximum credit from $500 to $550, and would have increased the phaseout range from between $6,000 and $10,000 to between $8,000 and $12,000. This proposal would involve a revenue loss of $0.7 billion per year and would raise the 1984 tax entry point to $9,472 for a three-person family, $9,938 for a four-person family and $10,844 for a six-person family.[1]

Zero bracket amount

Increasing the zero bracket amount is also a relatively cost-effective way of providing tax relief to poor people because the tax reduction does not go to the taxpayers who itemize their deductions. However, married couples receive the same ZBA regardless of their family size; and, therefore, it too is not a very good way of providing relief to the large families. Sizable increases in the ZBA would be needed to raise the income tax thresholds of single people and married couples up to the poverty level (a $2,000 increase for single people to $4,300 and a $1,400 increase for married couples to $4,800). The revenue loss from increases of this magnitude would be $16.6 billion per year.

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[1] The budget deficit reduction revenue provision recently approved by the Senate Committee on Finance would increase the earned income credit to 10.5 percent and raise the income level at which the maximum credit ($525) is fully phased-out to $11,000. These changes would be effective for taxable year beginning after 1984.

Personal exemption

Substantial increases in the personal exemption would be necessary to raise the tax threshold for large families up to the poverty level for them. The difference between the poverty lines for four- and five-person families is amost $2,000, and it is over $1,600 between five- and six-person families. Therefore, a personal exemption of around $1,800 would be needed to provide the difference in tax entry points between four-, five-, and six-person families that would correspond to their respective poverty lines. An increase of this magnitude would involve a revenue loss of $33.8 billion a year.

Combined tax changes

It would be possible to enact some or all of these increases in the earned income credit, ZBA or personal exemption and pay for them by raising tax rates. Alternatively, they could be paid for by expanding the tax base.